A New World Monetary System: Keynes' view revisited

Shehu Tijjani Mohammed

Bayero University Kano, Nigeria

7. November 2009

A new world monetary system: Keynes' view revisited

SHEHU TIJJANI MOHAMMED

Abstract

This essay critically examines the view of Keynes on the reform of the international monetary system. We then apply modern monetary and banking theory, where money is redefined as a pure numerical vehicle in contrast to money being defined as a net asset, to appraise those elements that are required for a functioning and efficient international monetary system. It is suggested that Keynes' view are still very much relevant today if the world is to move from the present *non-system* of international monetary arrangements to a system where currencies would no longer be perceived as net assets and countries would no longer be grouped as key and non-key currency countries.

Introduction

In 1998[1], at the annual meeting of the IMF and the World Bank, finance ministers of 22-countries formed a working group to discuss proposals whose aim is to create ultimately a 'new architecture' for the world monetary system. It means that the present international monetary arrangement is faulty.

The world has seen so far three types of international monetary arrangements or systems: The gold standard, the gold-exchange standard, and the present floating exchange rate system. Economists are well aware of these standards so that we do not need to elaborate on them. What we need to realize is that the gold standard and the gold-exchange standard actually stand for the sterling standard and the dollar exchange standard, respectively. The use of the two standards coincides with the economic position occupied by Great Britain prior to 1931 and the United States up to 1971. Each of the two standards was founded upon the ability of these two economies to provide the means of payments for the increasing volume of world trade and payments. But since the two standards were based on the commodity gold, a point is reached when the two countries can no longer cope: Sterling exchange standard collapsed in 1931, after an unsuccessful attempt by Britain to return to the pre-war level of exchange rate; and dollar exchange standard collapsed in 1971 when convertibility was suspended or more accurately when the gold content of the dollar was stripped off so that the dollar becomes in effect a mere IOU issued by the American banking system.

Since 1971 nearly all countries have instituted the floating exchange rate regimes. What we need to note is that the Bretton Woods arrangement in which the dollar is made to exchange against gold at a price of $35/ounce has been jettisoned. But while the regime of payments has changed from gold-exchange to the present multiple

[1] See International Economic Trends, Feb. 2000.

currency standard, the two institutions that were established to provide the necessary framework for the efficient working of the Bretton Woods system - the then world monetary system proper - continue to operate as if the world has a 'world monetary system' in place. The contradiction of the present arrangement is that while the world has no systematic monetary arrangement in place, it continues to support institutions that were made for the then world monetary system. In short, presently we have a non-system of payments in place; whilst the framework for supporting the then systematic payment arrangements is now used to support a non-system of international payment arrangements. The pathological system now in place has created the need for a reexamination of the present arrangement and the creation of a new architecture of international payments.

This paper addresses the need for a new world monetary system by reappraising some of the key elements proposed by Keynes. These requirements, as will become clear in the following pages, are still very much relevant today. In the following section we look critically at those elements that characterize the present world monetary system, which are hampering the smooth functioning of the system. The two elements we shall consider are (1) the double standard of value and international reserve assets. It shall be seen that the problems of the present international monetary arrangement are hinged on these two elements.

1.1 The double standard of value

A domestic currency that equally serves as international standard becomes a double standard of value. At one extreme it is the standard by which domestic production is measured, and, at the other extreme, it is the standard by which production, which occurred elsewhere, is also measured. At home it serves this function well, as it

rigorously obeys the rules that 'money should not have a price.' But as soon as it began to serve as international standard it becomes an object with a price tag subject to purchase and sale. This dual character of a currency whose function goes beyond the banking system which issues it serves to expose the inadequacy of the present system of international payments. It led to what Rueff (1967) called the ‘two pyramids of credit,’ a duplication of credit arising out of the use of a national currency as international standard. The volatility of exchange rates and the dominance of finance over trade is the result of the existence of double standard of value. The emergence of the Eurodollar market where dollar deposits are re-invested offshore for whatever reason is a result of the role of double standard of value, which the dollar is made to play. This also led to the difficulties experienced by countries not only in international payments but in the accumulation of debts as well - the two ever threatening the stability of the world monetary and financial system. It should be noted that the existence of the double standard of value or what can properly be called the ‘dollar standard’, since for a long term the dollar has been serving this dual role, arose out of the then Bretton Woods payment arrangements. It was never imposed by the United States on the rest of world.

Another outcome of the Bretton Woods arrangement is the need for countries to keep international reserves in order to back up the external value of their domestic currencies. Despite the demise of the Bretton Woods arrangement, international reserves remain an essential component of the present world monetary system. We shall look into the nature of external reserves in order to see whether they are capable of backing the international value of domestic currencies.

1.2 External reserves and the international value of domestic currency.

A look at the volatility of exchange rates suggests that countries upon countries are

losing the battle in their attempts to stabilize the exchange rates through what is known as ‘managed float’. If, despite the accumulation of large reserves, exchange rates remain volatile; then it does mean that either the accumulation of external reserves is incapable of assuring the stability of the external value of the domestic currency or central banks are incapable of maintaining stable exchange rates through the instruments of monetary policies. What then are external reserves and why do countries need them?

External reserves are internationally recognized ‘assets’ that a country accumulates in order to back the international value of its domestic currency and to meet the criterion of credit worthiness in international transactions. The emergence of this requirement can be traced back to over half a century ago when several countries met at a conference in Bretton Woods, to fashion out a new international monetary order. The assets that were to serve as the components of international reserves include: gold and convertible currencies; later Special Drawing Rights (SDRs) was added. These were regarded and accepted as ‘assets’. That is, they are accepted as real goods (in much the same way as a non-monetary financial bonds). In order to evaluate whether external reserves can adequately serve as a cover for the international value of a domestic currency, we need to enquire into the nature of those assets that are used as international reserves. For any asset to serve as external reserves its value must be stable; otherwise variations in its value lead to variations in the domestic currency to which it is anchored. Let us take each of the three most widely used international reserves assets (gold, reserve currencies and SDRs), to see whether they meet this criterion.

First, consider gold. Gold is a commodity that has two distinct properties: a use-value and an exchange value. Beside the use of gold for personal aggrandizement

and its usage in the industry, gold was also used as a means of exchange – first at the national level, then at the international level. That is gold performed the functions of money: basically, a measure and a store of value. The uniqueness of gold does not, however, single it out as a unique and invariable measure of value. The value of gold can vary due to several factors, particularly changes in production conditions and variations in its price due to changes in demand and supply. In addition 'gold's negligible elasticity of production (i.e a normally small, annual growth of its supply not determined by its price) explains not only its most attractive characteristic for use as world money but ironically also its gradual demise. There simply has not been enough additional gold available world-wide to satisfy the growing needs for international liquidity in the wake of expanding world trade. Consequently, gold as commodity money has been gradually replaced by credit money both in domestic circulation and as world money (Guttman, 1988, p.53). Any commodity that must serve as money ought to have a stable value; otherwise, if its value varies continuously as all other commodities which it was supposed to measure, then difficulties arise as to how to measure the value of all other commodities. Variations in the value of gold thus make it devoid of both a necessary and sufficient condition as a means of measuring the value of all other commodities and of serving as a repository of value.

Despite this shortcoming of gold, it is still being used as a means of payment, although only at the international level; and it is one of the commodities traded in commodity exchanges around the world. At the national level, gold is no longer seeing as a measure of value or as a means of exchange. Bank money devoid of any commodity affiliation has taken over. But as we have said earlier, old habits die hard so that, at the international level, gold still commands respect. As a result, countries still accumulate idle metals in their vaults, even though in modern economies, its

proportional use, even at the international level has shrunk. A look at the table below shows that while foreign currencies have become the dominant reserve assets, gold and SDRs have fallen to a point where their use as means of international payments have become negligible. Gold, from being the dominant means of payments in the 1920s fell to 18% of the total value of assets used as international means of payment by 1976. In fact by 1998, it constitutes about 3%. SDRs have also not fared better. We shall have more to say on the relative importance of SDRs later in this section. What we need to note for now is that it too, like gold, has suffered a severe decline to the extent that by 1998 it accounts for approximately a mere 2% of the total value of international reserve assets.

Table 1
International liquidity

	1929		**1976**		**1998**	
	US$b	**%**	**US$b**	**%**	**US$b**	**%**
Gold	10.2	69	42	18	33,786.6[a]	2.8
Currency	4.5	31	166	70	1,166,206[b]	95.5
SDRs	-	-	28	12	20,379.7[c]	1.68

Sources: IMF, International Financial Statistics, vol. L11, 1999.
a, b, c, are valued in SDRs

Nevertheless, gold is still very much present. Any look at the assets side of Central Banks balance sheets will confirm its importance. But given the present circumstances in which bank money has overtaken the use of gold as money, is it still meaningful to accumulate this metal as a means for backing the international value of a domestic

currency? Definitely not. Today most international payments are carried out with the use of one or a few key currencies such as the US dollar, Euro or Japanese Yen. Furthermore, accumulating gold reserves yields little or nothing in return. Since gold is experiencing decreasing share in the total amount of external reserves, how then can its accumulation back the international value of domestic currencies, when, instead, the use of key currencies has largely taken over as a means of international reserves? How can, in addition, as we have pointed out earlier, a commodity whose value varies be employed as a means of stabilizing the value of domestic currencies? It is simply impossible. Gold, then, is a relic of the past. Its use as a means of backing the international value of a domestic currency has become anachronistic and in the construction of any new architecture of international monetary system, it should be done away with for good.

But what about key currencies, that have largely assumed great importance as a means of settling international obligations and as a store of value? Given the fact that they have largely taken over from gold the role of international money, have they performed creditably in supporting the international value of domestic currencies? Save for the period of the gold-exchange standard, the answer to this question is negative. Let us investigate the nature of currencies used as international standard so as to see whether they perform better than gold.

The first question we need to ask is this: are key currencies assets? That is to say, can we safely regard key currencies as assets (real or financial). A key currency, first and foremost, is issued by a national banking system. As a result it constitutes an acknowledgement of debt of the banking system that issues it. If that is the case, it cannot be regarded as an asset outside the banking system that issues it. First, currencies do not pertain to real goods, they are a mere claim on deposits. Second, if we

regard them as real, we are saying in effect that the banking system of a country can create money out of nothing. It means that we agree to the erroneous association of a mere vehicle with purchasing power. As is clearly pointed out by Cencini

> The primary function of money is that of a unit of account. The meaning conveyed by this expression is clear: money is used to express real goods and services numerically. It immediately follows that money cannot be a commodity (if money were a commodity, it would have to be expressed in monetary terms so that money would have to be conceived as the unit of account of money itself). To avoid any risk of circular reasoning money must be assimilated to numbers. This means that money is essentially immaterial. One of the main difficulties we are faced with here is to admit of an immaterial entity capable of transferring physically heterogeneous goods and services into homogeneous commodities. The world of monetary economics is real and immaterial at the same time. What distinguishes the physical from the economic world is precisely the fact that, thanks to money, products are numerically accounted for. In the absence of money, products would not be given their economic form, and economics would be deprived of its own object of enquiry. (2001, p. 23)

Thus a currency issued within a banking system represents the output produced within the economy in which it is issued. Banks issue currencies in order to facilitate the transfer of income from one economic agent to another. By themselves they are a mere token. Neoclassical economics rigorously distinguishes between nominal and real variables. Money is a simple numerical vehicle, and currencies are a mere claims

‘whose object is a bank deposit’ (ibid.: 23). Consequently, issued by the banking system, key currencies used as reserve assets have the value of domestic output. They are issued in order to enable domestic economic agents carry out transactions involving production and exchange of goods and services and the discharge of debts. At the international level, however, there is no international production. All that we have are nationally produced goods moving across one country to another. The value of these goods has already been accounted for in national money. Their costs of production represent the income that is paid to factors in the production process in the form of wages, interest, rent and profit. This is why Ricardo in his characteristic acute observation of reality said that:

> No extension of foreign trade will immediately increase the amount of value in a country, although it will very powerfully contribute to increase the mass of commodities and therefore the sum of enjoyments. As the value of all foreign goods is measured by the quantity of the produce of our land and labor, which is given in exchange for them, we should have no greater value, if by the discovery of new markets, we obtain double the quantity of ours. (1971, p. 147)

Thus having the value of domestic output, currencies used as reserve assets are devoid of any content outside their point of emission. They account for national output where they are issued; they cannot at the same time account for what is produced elsewhere; for what is produced elsewhere has already been accounted for. In the light of this, it is a wonder how the world came to accept the use of a currency issued by a national banking system as an international standard and as a store of value. If it is an anomaly to use currencies issued at the national level as international standard, is it acceptable to

use it as a store of value?

In order to perform this task, the value of the currency used as international standard must be stable. If its value is not stable, then obviously, the value of domestic currency, which is anchored to it cannot remain stable. According to Guttmann:

> Given the large swings of exchange rates since 1971 none of the key currencies has functioned as an effective unit of account, with which to maintain relatively stable international prices, or performed sufficiently well as store of value. (1988, p. 261)

As we have noted earlier, quite apart from variations arising out of the normal course of trade, these currencies are subject to speculative attacks due to their pathological nature. Jacque Rueff (1967) pointed this out eloquently. 'Entering the national banking system, but remaining in the debtor country, the claim representing the deposits is thus doubled.' This leads to he called, 'two pyramids of credit'. The payment of commercial deficits in key currencies thus represents double claims by both domestic and foreign economic agents. As a result of their pathological nature, the use of these currencies as reserve assets do not ensure the stability of the international value of a domestic non-key currency. Since they cannot control how their credits are utilized by the domestic banking system in which they are deposited, the stability of the non-key currency depends on the monetary and fiscal policy pursued by the country enjoying the status of key currency. Perhaps then SDRs, being an internationally issued assets will perform better than gold and hard currencies as reserve assets, again, the analysis below gives cause for doubt.

SDRs, an acronym for Special Drawing Rights, is a facility that was created by the IMF as an international reserve asset alongside the dollar and gold. 'These special drawing rights, created as it were, by a stroke of the pen, will be essentially entries in

the books of the Fund'(Schweitser, in Cencini and Schmitt, 1991, p. 80). The value of SDRs depends on its acceptance by the participants who shall provide in exchange convertible currency or gold. The intention of the Fund was to make SDRs the principal reserve asset of the world monetary system. But the question is, are the created SDRs any different from the foreign currencies that are used as international standards? Issued as a reserve asset, SDRs were therefore thought to be issued with a positive value irrespective of their being used at the international level and, thus, irrespective of their link with real output. While dollars are issued by the American banking system SDRS, however, are created by an international organism, and this seemed enough to avoid the injustice of letting a country purchase foreign currencies by the simple remittance of its own IOUs. Indeed, if some countries are still not entirely satisfied with this situation, it is merely because the SDRs are allocated on the basis of quotas, which makes it practically impossible for most LDCs to obtain them without increasing their external debt (Cencini and Schmitt, 1991, p. 81).

The rate of exchange of SDRs is calculated on the basis of a basket of a few hard currencies, an indication that its value cannot be expected to remain stable for long. Due to incessant variation in the members of the set of currencies used, the weight will continually change. Besides, countries using SDRs have to provide convertible currencies, again back to the same problem. In addition, the incapacity of the leading industrial countries to agree on the emission of SDRs by the IMF has constantly decreased the use of this international facility and postponed *sine die* the replacement of the US dollar by the SDR (ibid.: 82). The declining use of SDRs as compared to the US dollar indicates that much of foreign reserve assets will continue to be denominated in dollar. (See Table 1.) Consequently SDRs cannot be relied upon as a means of backing the international value of a domestic currency. Besides its use is no different from the

use of the US dollar. 'In reality, the use of SDRs as final payment is not essentially different from the use of dollars made by USA: in both cases a book-keeping entry of no real value is given in exchange for a positive amount of national currencies (ibid.: 83). If these were the case, why are countries still holding large amount of reserves. Accoding to the Economist[2], 'The holding of large official reserves is a hangover from the Bretton Woods system of fixed exchange rates, under which countries were obliged to defend their parities through official intervention. Yet Bretton Woods broke down almost 30 years ago, and the shift to floating exchange rates and the expansion of international capital markets, which has improved countries access to foreign borrowing should have reduced the need to hold reserves. But global foreign – exchange reserves are now higher in relation to trade flows than at almost any time in history. The ratio of foreign exchange reserves to imports has risen from 12% in 1969 to 30% in (2000). The holding of large reserves arises from the weaknesses of the old system as it fails to treat symmetrically surplus and deficit countries.'

As we have been arguing, reserve assets are unstable instruments and thus incapable of being used as a means of stabilizing the international value of domestic currencies. Besides, 'official reserves are not part of the quantity of money monetizing national output and their reduction cannot have, therefore, a deflationary impact within the deficit country' (Cencini, 1995, p. 175).

In the new architecture of world monetary system, therefore, they have to be done away with completely.

2.0 The basic requirements for an efficient international monetary system

In order to enunciate an orderly payments arrangement, according to Keynes (see

[2] See The Economist September 2nd 2000.

Davidson, 1992, p. 158):

> We need *an instrument of international currency* having general acceptability between nations…We need an orderly and agreed upon *method of determining the relative exchange values of national currency units*…We need *a quantum of international currency*…which is governed by the actual current [liquidity] requirements of world commerce, and is capable of deliberate expansion…We need *a method by which the surplus credit balances arising from international trade, which the recipient does not wish to employ can be set to work*…without detriment to the liquidity of these balances. [Emphasis added].

Accordingly, a new world monetary system would need (1) an international currency, (2) a new method to determine relative exchange rates, (3) a quantum of international currency that will match the need of world trade, and (4) a new method by which surpluses arising out of trade will be channelled to productive use. These requirements as we shall see below are interrelated. We turn now to consider the four basic requirements for an effective international monetary system, which were first enunciated by Keynes

2.1 International currency and a clearing union

Keynes' plan is anchored on the creation of a supranational institution that will be responsible for providing the means for settling international imbalances among

countries. This institution was to be designated an International Clearing Union (ICU). The Union will be responsible for homogenizing the world's monetary space for both surplus and deficit countries by generalizing 'the essential principle of banking as it is exhibited within any closed system. This principle is the necessary, equality of credits and debits' (Keynes, in Cencini, 1991, p. 108). As is well known, money issued within the domestic banking system of a country has the value of the output produced in that country as its object. The financial intermediaries are responsible for conveying, with the issue of money, income produced within the economy, from one economic agent to another. In order for this operation to apply smoothly within the financial system of the domestic economy, a central bank is required to reconcile the balances of the financial intermediaries through the provision of a clearing facility. The business of clearing has been going on since the creation of central banks, and central banks appeared to have performed this role excellently. This role is performed by the application of simple double entry accounting to banking, in which, 'no credits can be removed outside the clearing system, but only transferred within it ' (Cencini, 1995, p. 113).

Payments made to economic agents are instantly recorded as deposits to their benefits within the banking system. The debit of the payer defines the credit of payee. If this principle was to be extended to the international level, then obviously two things are required: an International Clearing Union and a world currency. In order to achieve this 'we need an instrument of international currency having general acceptability between nations, so that blocked balances and bilateral clearings are unnecessary…' (Keynes, in Cencini, 1995, p. 137). There is then a need for an international currency capable of conveying international incomes among countries. This currency is to be called 'bancor' according to Keynes. The bancor defined in terms of gold was to be used as the sole means of international payments.

> The proposal is to establish a currency union, here designated an International Clearing Union, based on international bank money, called (let us say) bancor, fixed (but not unalterably) in terms of gold and accepted as the equivalent of gold by the British Commonwealth and the United States and all the other members of the Union for the purpose of settling international balances (ibid.: 137).

The *bancor* thus homogenizes the world's monetary space in a heterogeneous currency world. It becomes a numerical vehicle whose value derives from its association with gold. The beauty of the Keynes' plan appear to be that by analogy to what happens at the national level, the clearing institution would provide its clients with the currency necessary for international circulation, being certain to recover the money it creates and which, transferred from the importing to exporting country, defines the deposit of the latter. As claimed by Keynes, the Clearing Union would never be uncovered, since the debt of a country would always be matched by the credit of another country, and, therefore, by its deposit in bancor with the World Bank. This does not mean that a country can import without limits, in the certainty that its net purchases are automatically financed by an equivalent deposit of exporting countries. The equality of debits and credits implies no mechanism of this sort. In order to effectively pay for its net commercial imports, a country must sell bonds of an equal amount, and this sale can certainly not be ensured by the simple monetary intermediation carried out by the International Clearing Union. Hence, whereas monetary equilibrium is always guaranteed by the book-keeping principle, financial equilibrium requires the World Bank to intervene in its function as financial intermediary (ibid.: 140).

Despite the great advance which Keynes plan contains, the issue that members of the Union should accept the bancor 'as if it were gold' became contentious. This is the

way Cencini put the matter:

> Now, national and international money do not pertain to the same category. National currencies do not effectively derive their value from gold, but from the production of goods and services they are associated with. The bancor, on the contrary, cannot find its value in any international production (since world output is simply the sum of national outputs). Hence, while gold parity is superfluous at the national level, as far as the bancor is concerned, it seems necessary to link it with a particular good of indisputable value such as gold. At this point the problem becomes complicated. If countries are bound to accept the bancor according to its gold parity, and if the bancor is created by the World Bank on request of Clearing Union members, how is it possible to simultaneously provide the world, with the necessary international liquidity and avoid the emission of money which is not backed by the necessary reserves? (ibid.: 141).

However, this shortcoming in the Keynes' plan can easily be removed if we are ready to accept the fact that money, whether national or international should be regarded as was pointed out by Keynes himself, as 'bank money'. Thus a redefinition of money is called for.

2.2 A redefinition of money

Money has usually been regarded as anything that is generally accepted as a medium of exchange. Its functions include a measure of value, a unit of account and a store of value. Commodities of various shades and varieties have, at one time or another, served as money. The historical development of money has shown that money evolved from

being a commodity (a real good) into a mere token. Modern day money is, however, essentially bank money. In his Treatise on Money, Keynes classified money into two: money and money of account. According to Keynes

> Money of account, namely that in which debts and prices and general purchasing power are expressed, is the primary concept of money. A money of account comes into existence along with debts which are contracts for deferred payment, and price lists, which are offers of contracts for sale or purchase. Such debts and price lists, whether they are recorded by word of mouth or by book entry on baked bricks or paper documents, can only be expressed in terms of money of account. Money itself, namely that by delivery of which debt contracts and price contracts are discharged, and in the shape of which a store of general purchasing power is held, derives its character from its relationship to the money of account, since the debts and prices must first have been expressed in terms of the latter. (1971, p. 3)

He continues to say that:

> Something which is merely used as a convenient medium of exchange on the spot may approach to being money, in as much as it may represent a means of holding general purchasing power. But if this is all, we have scarcely emerged from the stage of barter. Money proper in the full sense of the term can only exist in relation to money of account(ibid.:3).

Having made this distinction, Keynes went on to say that 'Bank money is simply an acknowledgement of a private debt, expressed in the money of account, which is used

by passing from one hand to another, alternatively with money proper, to settle a transaction.' The clue Keynes gave us as to the proper meaning of money lies in the fact that 'all the current money in the hands of the public is member bank money, i.e bank deposits'(ibid.: 27). Money is then a simple numerical form, which is issued by the banking system in carrying out its functions as facilitator of payments and financial go-between – transferring value from one economic agent to another. This line of thought was vigorously pursued by Cencini (1995, p. 3), arguing that 'money is a very peculiar object, which has too often been mistaken for a real good.' Modern monetary theory teaches that it is anachronistic to conceive money from a physical point of view. 'By creating money, banks simply provide the economy with a numerical means of payment, the object of the payment being derived from the association of money with current output' (ibid.:3). Money then is not a commodity, a real good, but a pure numerical form that is used to convey real goods from one economic agent to another. Money and current output does display an identity from which one cannot be disentangled from the other. An understanding of money in this way is very crucial, as it helps to avoid the mixing of money proper with its object – the real goods that it helps to circulate. To avoid confusion, money and financial assets need to be rigorously separated.

2.21 Money and financial assets

> If 'impossible' lives in utopia, it is certainly not utopian to suppose that, once achieved, scientific progress may take hold of people's mind, especially if the well-being of whole populations depends on it…Bank money is a *means* of payment and not a net *asset* (bank money is an object of *mediation* and not a final product)…(See

Schmitt, in Cencini, 2000, p. 19) [italics in the original]

Given the fact that money is simply a numerical form issued by the banking system so that it cannot be equated to real goods; can financial assets be regarded as real goods? The answer to this question is, unmistakably, positive. The reason is that financial assets are issued as promises to pay future income for the use of current one. This is because 'While money is a simple numerical vehicle allowing the flow of payments, credit implies a financial transfer of income. While money has no value of its own and can indeed be created, income derives from production and defines an absolute exchange between a real and a monetary deposit' (Cencini 2007: 7). Accordingly, 'Credit is concerned with the lending of such a deposit. It appears thus that the supply of credit must be kept distinct from that of money. The monetarist concept of money is ill-founded because assuming money to be a positive asset, it confuses money with income. In fact it is income that is a positive asset. The supply of credit is the supply of a positive amount of income and acquires the existence of a bank deposit(a stock), whereas the supply of money refers to the capacity of banks to convey payments(flows) on behalf of their clients. By failing to distinguish clearly between these two functions (monetary and financial intermediations) carried out by banks, economists have been led to develop an anachronistic conception of money, inconsistent with its book-keeping nature and incapable of explaining the working of our monetary economics of production' (ibid.: 7).

The analysis above applies equally to all financial assets: bonds, commercial paper, etc. A bond, for example, is a simple promise to pay a sum (called principal and interest), at a future date. The issuer of the bond seeks current income. The holder of the

bond, on the other hand, agrees to part with current income for future income. Thus bonds and other non-monetary financial assets represent real goods. Our so-called international ‘reserve assets’ do not meet this simple criterion and that is why they are to be dispensed with in the construction of any new architecture of international monetary system. This leads us into another element of the new international monetary system: the required exchange rate regime.

2.3 Freely floating absolute exchange rate regime

There are two additional elements, aside from removing protective tariffs and other impediments to free trade, that are required in order for trade to flourish unhindered among nations: first, a flexible exchange rate regime, and second an exchange rate that is stable over time. This much is recognized. However while the first is achievable, the second, due to several factors, namely volatility of financial flows, speculative behavior, financial fragility, contiguous effects, etc, is difficult or almost impossible to achieve. Over thirty years after floating exchange rate regimes become operational in the major industrialized countries and in much of the developing countries, a stable exchange rate has become a mere fiction. Moreover, despite the responses of economic actors to limit the devastating effects and to insulate themselves against adverse movements in exchange rates through the creation of hedging instruments, it appears that the instruments are weak so that they are incapable of moving against large swings in exchange rates. The time has thus come to reexamine this problems so as to kill two birds with one stone: to achieve stable exchange rates in the face of floating exchange rates. For each economic actor, for each country, and for the world economy as a whole,

this would represent the desired state they have been yearning for.

In traditional analysis of exchange rates, exchange rates are regarded as the relative prices of national currencies when exchanged against one another, because money is regarded as a net asset. This leads to the application of the tools of demand and supply in order to determine the relative price of foreign exchange. But if modern money cannot be regarded as a net asset but as a purely vehicular means of mediating exchange, then the conception of money as a net asset has to be abandoned in favor of the superior conception of money as a two sided coin: as an asset on one side and a liability on the other. Thus the first task is to recognize modern money as bank money – a mere acknowledgement of debt issued by the banking system. It is a mere I.O.U. Bank money is both an asset and a liability. And as such it must not have a price. It is represented by simple book-keeping entries. Thus money cannot be assimilated to real goods it is made to circulate. Once this is recognized, the idea of an absolute exchange rate becomes easy to grasp. Cencini put it succinctly as follows:

> The transition from relative to absolute exchange rates is …that from a system in which money is an *object* of payment to one in which money is a *means* of payment; from a system in which money is itself an asset to one in which real and financial assets are 'circulated' by money. It is the circular use of money that, as in Keynes's plan of reform, allows for the stability of exchange rate. (1995, p. 14)

For this to be achieved, it will require two interrelated factors: (i) a reciprocal demand for currencies, and (ii) the sale and purchase of financial bonds. In a regime of absolute exchange rate no foreign currency is to be entered on the assets side of a net exporting

country's balance sheet as the final counterpart of its net commercial exports. Payments made by net importers should immediately flow back into its banking system paving the way for the sale of financial assets (shares or bonds) as a means of settling its international payments. 'This means that a net commercial surplus must be counterbalanced by an equivalent net purchase of securities, the country whose balance of trade is in surplus being a net importer on the financial market' (Cencini, 2000, p. 15). This means that as soon as its net commercial exports are paid for, the surplus country would not enter a sum of foreign currencies on the assets side of its banking system's balance sheet, but instead use the sum to purchase foreign securities. A regime of absolute exchange rate will thus see to it that no country can use its currency as the final means of payments. If eventually an international monetary unit is created – call it bancor, unitas, icu, and so on – this regime will find its logical expression in the unit chosen as the international standard. For then, 'each national currency is changed into the international money and not exchanged against it or against another national currency' (ibid.: 15).

The problem with the present international monetary system is that it allows apparently the exchange of equivalents, but in actual fact, real goods are exchanged for mere acknowledgement of debt. The payment system is asymmetrical. This is due to the existence of what is known as the 'reserve currency'. Given two countries in which one is a reserve and the other a nonreserve currency country, the former is given the privilege to pay its net commercial imports in its own money. That is by simply transferring to its creditors a claim on its own deposits. But these deposits have by no means constituted final payment to its creditors. In other to effectively pay its creditors, the reserve currency country ought to sell to its creditors financial assets of equivalent value or be a net exporter of goods and services. If this transaction occurs between a

reserve and a nonreserve currency country, the purchase of these assets by the latter would represent claims on the future output of the former. Until the nonreserve currency country receives this output, the reserve currency country has not made effective payments for its net commercial imports. With the existence of international money and a clearing union in which the rules of double-entry book-keeping will be made to rigorously apply, equivalent output will be transferred instantaneously between the two countries, and the four requirements outlined by Keynes in his reform plan will become fully operational.

2.4 Conclusion

The analysis above indicated some of the elements that will need to be incorporated in any new arrangement of international monetary system. The new arrangement will do away with debt servicing difficulties and the existence of 'two pyramids of credits,' which is a source of instability for the world economy. To put the new arrangement on a sound footing will need a redefinition of money, the separation of the creation of money and financial intermediation, and the creation of a global currency unit. We believe that an integrated financial market should be created with a clearing house whose responsibility is to issue world money and to monitor agreed upon world monetary policy – a monetary policy that will serve as a guide for national monetary policies. This we have done in the hope to stimulate the discovery of other elements by those who are strongly interested in seeing to the emergence of a global monetary system that is capable of launching the world economy back on the track of growth and development.

References

Burns, A. "Some Essentials of International Monetary Reform," *Federal Reserve Bulletin*, 1972, June, 545-549.

Cencini, A. *Monetary Theory: National and International*. London: Routledge, 1995.

------- "World Monetary Disorders: Exchange Rate Erratic Fluctuations," Working Papers, Center for Banking Studies and University of Lugano, Research Laboratory of Monetary Economics, Italy, 2000, 1-17.

------- *Monetary Macroeconomics: a new approach*. London: Routledge, 2001.

Cencini , A., and Schmitt, B. *External Debt Servicing: A vicious circle*. London: Pinter Publishers, 1991.

Davidson, P. "Reforming the world's money," *Journal of Post-Keynesian Economics*, 1992, 15 (2), 153-179.

Guttmann, R. "Crisis and Reform of the International Monetary System," in Philip Arestis (ed.) *Post-Keynesian Monetary Economics: New approaches to financial modeling*. Hants and Vermont: Edward Elgar, 1988.

Horie, S. *The International Monetary Fund: Retrospect and Prospect*. London: Macmillan, 1964.

Horsefield, K. *The International Monetary Fund: 1945-1965*. Washington D.C.: IMF, 1969.

Keynes, J. M. *A Treatise on Money*. London: Macmillan and Cambridge University Press, 1971.

Mundell R.A. "The International Monetary System: Quo Vadis," Discussion Paper

#:1002-34, Department of Economics, Columbia University, New York, NY 1022, 2002, 1-11.

Ricardo, D. *Principles of Political Economy and Taxation*. Middlesex, England: Penguin Books, 1971.

Rueff, J. "Gold Exchange Standard a Danger to the West," in H. G. Grubel (ed.) *World Monetary Reform: Plans and Issues*. Stanford: Stanford University Press, 1967.

Schulmeister, S. "Globalization without global money: the double role of the dollar as national currency and world money," *Journal of Post-Keynesian Economics*, 2000, vol. 22, No.3, 365-395.

Sercu, P., and Uppal, R. *International Financial Markets and the Firm*. Ohio: South-Western College, 1995.

Zolotas, X. *International Monetary Issues and Development Policies*. Athens: Bank of Greece, 1977.